AEGON Asset Management

Monthly outlook – February

Are we really casting pearls before swine?

Crisis management in Greece – no need for the "Greek yoghurt" recipe, we know it already

"Give not that which is holy unto the dogs, neither cast ye your pearls before swine, lest they trample them under their feet, and turn again and rend you." So it says in the first book of the New Testament, the Gospel of Matthew. But what are these pearls, and who are the pigs, and who is casting all this before them and why? Let us examine, therefore, the background to the complex question above.

Apart from its meaning in English, PIGS is a pejorative acronym in financial jargon which began to be used by British and North American journalists in 2008 in articles on economics and finance. The acronym is comprised of the initials in English of four Southern European countries: namely, Portugal, Italy, Greece and Spain. All of the countries in question are members of the European Economic and Monetary Union (EEMU), but at the same time have always been regarded as stragglers within the EEMU according to a number of criteria. Their economic performance is mixed, as they are mostly characterized by high levels of unemployment, a frequent lack of budgetary discipline and often serious current account deficits, the latter giving cause for concern over their stability due to mounting public debt. This has the knock-on effect of casting a shadow over the stability of the euro and the entire common economic area. Lately both Ireland and Great Britain have also joined the PIGS list, expanding the original acronym to PIIGGS. Let's not forget, however, that while the official currency in Ireland is the euro, in Great Britain the pound sterling remains in circulation. The Quantum Hedge Fund managed by Hungarian-born George Soros played a very considerable role in the latter, when it earned billions of US dollars by short-selling pounds sterling in 1992, bringing the Bank of England to its knees and forcing the UK – under the pressure of speculation – to withdraw from the European Exchange Rate Mechanism (ERM). By an interesting quirk of fate, looking at the events with the benefit of hindsight this was not necessarily an unfavourable development for the country.

In the 27-member European Union, the deficit in public finances currently exceeds the stipulated limit of 3% of GDP in 20 member countries. In most cases (but not exclusively), the cause of this can be sought in a global economic crisis the like of which the world has not experienced since 1930, which has resulted in a severe imbalance due to increasing public expenditures. As in every group, there is a ringleader in this regard, which in the present case is none other than Greece. Following the elections held in October last year, a new government was formed under the leadership of George Papandreou. Details about the state of the Greek economy that have emerged at a frantic pace in the intervening time suggest an ever-deepening and expanding morass. If change is not forthcoming, then the public finance deficit could deteriorate to 14.5% of GDP while the national debt could increase to as much as 124% of GDP. Added to all this are such "tit-bits" as the unpaid debts of state-owned businesses amounting to 2-3% of GDP or the irresponsible undertaking of guarantees by the Greek government. It is also perhaps unsurprising that numerous measures, creative accounts and bogus statistical data have also come to light that were designed to gloss over the real situation. A very good example of the latter is the introduction of the euro in Greece in 2001, when although on paper the public finance deficit – as an indication of budgetary restraint – was well below the 3% of GDP defined in the Maastricht criteria, in reality it was significantly beyond the permitted limit.

The European Commission, meanwhile, launched a procedure for violation of the law against the country as the Greek government supplied false data regarding the actual size of the national debt. By the end of 2009, Greece's budget deficit was approaching 13% of GDP, thus far overstepping the earlier prognosticated figure. Last month the Papandreou government elaborated a package of measures aimed at forcing the budget deficit down below the stipulated threshold of 3% of GDP

permitted in the European Union. Athens intends to achieve this goal by reducing expenditures and increasing tax revenues. We therefore have no need for the recipe for "Greek yoghurt", as Greece's crisis management is strikingly similar to that earlier implemented in Hungary. Under the plan, large-scale austerity measures (wage freezes, wage reductions) will be applied in the Greek public sphere in the near future in order to bring the budget deficit down to 8.7% of GDP in 2010. The deficit target for 2011 is 5.6%, and 2.8% for 2012. Additional measures will also be employed to reduce the deficit, such as, for example, increasing taxes levied on fuels or raising the age of retirement.

The euro has also been impacted by the problems in Greece's public finances. The Euro Index has significantly declined, signalling that the common European currency has weakened substantially against the basket of five other currencies (USD, GBP, JPY, CHF, SEK). Certain other assumptions have also emerged indicating that the EUR/USD rate may sink as low as 1.20 by the end of the year. The weakening of the euro is not yet the end of the world in itself; indeed, it improves the EU's export opportunities and points towards an improvement in competitiveness, not to mention the fact that all this creates an excellent opportunity for central banks to reduce the current role of the US dollar – which is stronger than earlier – as a reserve currency. Central banks' foreign currency reserves are overwhelmingly USD-centred, so there was understandable panic when the greenback reached the level of 1.60 against the euro. With the USD now stronger, however, central banks have the chance to – albeit carefully – reduce their exposure.

What is really worrying is that the debt crisis may impact the whole of the 16-member euro zone, both directly and indirectly. Following one possible train of thought, a potential Greek sovereign bankruptcy – which will almost certainly not occur as it simply can't be allowed to – would dramatically influence the situation of countries similar to Greece (with high public finance deficits and high national debt), whether these be in the EEMU, or merely within the EU. According to George Soros and the Nobel Prize-winning economist Joseph Stiglitz, however, it is absurd to hypothesize the sovereign bankruptcy of an EU member state.

In the end, the Greek example reveals where an unsound economic policy financed from credit can lead: to a situation close to sovereign bankruptcy. It must be recognized that the Greek government's measures will in all likelihood prove insufficient in themselves, even in the event that they are implemented with draconian rigour – not to mention that they are already massively opposed by the Greek people. The country will very soon need to fall back on international assistance (from the EU, ECB, World Bank, IMF, etc.) in order to avoid insolvency. The "pearls," therefore, are very much needed, but only if the Greek government also implements very profound structural changes in its budgetary policy. All this must also be carried out by the other countries in a similar boat because the EU cannot set a negative precedent that might encourage the other "pigs", either within or outside the sty, to carry on with everything as before in the belief that liberating forces will eventually turn up from the outside. In the event of several countries sinking close to bankruptcy one after the other, it is questionable whether the latter could even be covered. Greece is enormously fortunate to be a member of the EEMU, and its example demonstrates to us what would have happened if Hungary had allowed its already very high deficit indicators to run away in a similar fashion.

Main economic indicators of the countries in question looking ahead

	Growth outlook GDP (yoy, %)	Fiscal outlook Deficit/GDP*	Fiscal outlook Debt/GDP*	CDS**
Italy	0,5	-5,0	119	139
Spain	-0,7	-9,5	67	145
Ireland	-1,4	-11,6	78	154
Portugal	0,3	-8,8	85	210
Greece	-0,3	-14,5	124	375
Hungary	0	-6,5	84	262

*In percentage of GDP; 2010 expectation
** 5-year, basis point; 10 February 2010
Sources: Bloomberg, UniCredit Economics & FI/FX Research, AEGON Asset Management

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